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India: New Dimensions in Economic Policy

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An Intelligence Assessment

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India: New Dimensions in Economic Policy [redacted]

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An Intelligence Assessment

This assessment was prepared by [redacted] Office of Near East–South Asian Analysis. Comments and queries are welcome and may be directed to the Chief, South Asia Division, NESA, on [redacted]

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India: New Dimensions in Economic Policy

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Key Judgments

Information available as of 3 December 1982 was used in this report.

Since her return to office in January 1980, Prime Minister Gandhi has altered the restrictive trend of earlier Indian economic policy. She has eased the stranglehold of bureaucratic controls on industry and provided a more favorable policy climate for private investment. Gandhi's gradual and cautious liberalization measures have attracted the attention of Western policymakers and businessmen and have prompted optimistic speculation that these changes will eventually modify India's foreign policy, contribute to economic growth, and provide new opportunities for US business.

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Gandhi has no comprehensive strategy for economic reform, but a multitude of minor policy changes have:

- Removed many legal impediments to growth of production and investment, especially for export industries.
- Simplified import licensing procedures, especially those that impede exports, and recently permitted limited competition for domestic manufacturers.
- Encouraged technical cooperation with Western business and increased slightly India's tolerance of equity investment.
- Increased use of foreign commercial loans.

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India's new economic approach was prompted by dissatisfaction with past economic performance and by interest in the potential benefits of advanced Western technology. Gandhi's policy changes have not altered the basic regulatory structure that has long been in place. She regards her liberalization effort as an experiment—worth an extended trial but to be abandoned if production and exports fail to increase.

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Economic liberalization provides new opportunities for Indian industry to become more efficient. Decontrol efforts alone, however, are not sufficient to alleviate balance-of-payments problems or ensure faster economic growth. Overall economic performance has not yet benefited from Gandhi's policy changes, even though large companies report ambitious expansion plans and more technical cooperation agreements have been signed with foreign companies.

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A potential shortage of foreign exchange is the greatest threat to continued liberalization. Unless developments beyond the control of Gandhi's economic policy are favorable, she may have to reimpose some curbs on industrial imports in order to ensure India's ability to finance purchases of food, petroleum, and military equipment.

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NESA 83-10034
February 1983

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Economic policy changes are only loosely linked with Gandhi's simultaneous efforts to loosen somewhat India's close association with the Soviet Union. Although liberalization encourages additional trade and technology ties with Western countries, it will not eliminate Moscow's central place in New Delhi's foreign policy. Political friction with the United States could even increase slightly if Gandhi's hopes for technological links and economic progress are not realized.

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India: New Dimensions in Economic Policy

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Traditional Policies and Problems [1]

Since independence, Indian policymakers have tried to promote the often conflicting objectives of growth, equity, and self-reliance through pervasive government intervention in the economy. They supplemented a full range of macroeconomic policies with an extensive system of direct controls on investment, finance, prices, and foreign trade. During her earlier term as Prime Minister (1967-77) Indira Gandhi intensified restrictions on foreign companies and domestic "monopolies."

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Under these policies, overall GNP growth has been slower than in many low-income countries—about 3.6 percent a year since 1950—but India has succeeded in developing a sophisticated industrial base and improving rice and wheat production. Fears of famine and foreign exchange shortages receded in the late 1970s when India benefited from a series of good harvests and an inflow of remittances from Indian workers in the Middle East.

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Hopes for sustained economic progress were dashed soon after Gandhi returned to office in January 1980. Extremely poor weather in 1979 sent agricultural production plummeting. Interrelated shortages of electricity, coal, and rail services crippled industrial production and exports. India's balance of payments deteriorated following increases in international petroleum prices and political agitation in the northeastern state of Assam that disrupted domestic oil production. Indian officials feared that future development efforts would have to be curtailed because they anticipated a reduction in foreign aid commitments, particularly from the International Development Association.

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[1] Economic policy changes and the reactions of the private corporate sector are widely reported in India's extensive business and financial press, trade association publications, reports of commercial research organizations, and Indian Government publications. Our judgments in this assessment are based on detailed information in those open sources, supplemented by reporting from US Embassy and consular posts in India and analyses prepared by international financial institutions.

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Gandhi has relied primarily on traditional policy approaches to cope with these problems and boost national output. Her nagging and close supervision have spurred improved management of the public power, coal, and rail industries, although bottlenecks remain. She has continued support for agriculture through price supports and investment in irrigation. New Delhi is proceeding with plans for massive expansion of electricity generating capacity and is counting on petroleum exploration efforts to increase India's own crude oil production and reduce import costs. Gandhi has turned to international financial institutions for increased support and obtained a $5.7 billion Extended Fund Facility credit from the International Monetary Fund (IMF) in 1981.

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Supplementing the Old Cures

While Gandhi is continuing many traditional policy measures, she has taken a new approach to the private sector. A multitude of minor changes can be viewed as a new liberalization policy that loosens government controls on production and investment and permits more foreign participation in Indian industry. Gandhi began by relaxing specific impediments to production and exports. Very cautiously and gradually, she opened additional oppportunities for domestic and foreign business.

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A mixture of confidence and concern about India's economic prospects prompted the new economic approach. Gandhi was:

- Impelled to reconsider policy because economic problems were mounting.
- Able to risk change because of the leeway initially afforded by comfortable stocks of grain and foreign exchange and later by support from the IMF.
- Willing to experiment because she and her advisers were dissatisfied with past performance and believed that the economy has an unrealized potential to become strong.

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Gandhi's liberalization efforts reflect the gradual dissipation of support for comprehensive government controls since the 1950s. According to prominent Indian economic observers, many intellectuals and bureaucrats now admit that the plethora of government regulations has not only slowed growth but also hindered the achievement of social goals such as increased employment. Some of Gandhi's principal advisers share these views and have published studies that advocate a shift in policy emphasis from control to development. The probusiness sympathies of Gandhi's son Sanjay, who was her principal confidant until his death in June 1980, probably made his mother more receptive to these recommendations. [redacted]

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Gandhi's new approach is a pragmatic response to past economic difficulties and not a shift in overall economic ideology, which continues to favor strong government intervention in the economy. Although Gandhi's advisers argue that many government controls have not worked and should be dropped, they do not favor unfettered operation of market forces, which they believe would respond only to the interests of the affluent. In our judgment, Gandhi has never been deeply committed to any theoretical approach. Rather, the policies she has adopted during her two terms as Prime Minister suggest that she reacts to the most glaring political or economic problems. She has moved to the left in the past when that was expedient. Now, while she is experimenting with decontrol, her public statements still contain a vague socialist rhetoric. In 1982 she explained to a foreign interviewer that "our version of socialism is entirely different from what is practiced in the Soviet Union. . . . But . . . we must do something tangible for these vast millions of poor, and we cannot do it if we leave it to big business." [redacted]

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The Scope of Liberalization

Domestic Industry. Gandhi's initiatives to ease legal impediments to the growth of private industry constitute a marked shift from earlier policy restraints. Since the 1950s the central government has regulated the type and quantity of goods that may be produced and determined prices and distribution of several essential commodities. The Monopolies and Restrictive Trade Practices Act, passed during Gandhi's earlier term of office, imposed additional controls on investment and production by India's large, diversified industrial conglomerates.[2] Gandhi had barely begun to temper the rigor of her antimonopoly legislation when she lost the 1977 election. During the Janata interregnum, policies even more inimical to big business were often announced but seldom implemented. [redacted]

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Since Gandhi returned to office, she has removed some legal restrictions on increases in private-sector manufacturing and investment. Her industrial policy statement of mid-1980 "regularized" some capacity that had been installed in excess of licensed limits and authorized a few industries to expand slightly without special permission. She pushed the bureaucracy to reduce the time required to obtain industrial licenses and convinced officials that she wanted to spur output. A leading industrialist characterized these early changes as "probation rather than reprieve" for business. [redacted]

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India's largest corporations, excluded from the initial liberalization measures, have benefited from more recent changes. Export sales are no longer counted when determining whether a business is large enough to be subject to antimonopoly restrictions. The industrial policy announced in April 1982 opened new areas for investment by large or foreign-owned firms and authorized substantially higher capacity ceilings for growing companies. Industrialists nonetheless complain that they have gained relatively little, partly because the new rules are confusing and contain many qualifications, but also because much production has not reached licensed limits. [redacted]

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New Delhi has curbed its role in setting prices of essential industrial commodities and specifying distribution to preferred categories of customers. Private producers of cement, who account for 90 percent of production, are now permitted to sell one-third of their output to any customer at any price. A committee from one private and five public-sector steel plants—rather than the central government—now sets prices of steel. [redacted]

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[2] Companies subject to this Act account for 16 percent of Indian mining and manufacturing. [redacted]

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Domestic Industry: Selected Liberalization Measures

June 1980	*Right of government financial institutions to convert their loans to private companies into equity limited to 40-percent share of most companies, 51 percent of a mismanaged company.*	*Industrialists had feared the convertibility clause could lead to back-door nationalization, even though it had never been used for that purpose.*
July-August 1980	*"Regularized" capacity installed by some companies in excess of licensed limits. Permitted manufactures of some items in 19 industrial sectors to increase their production capacity by 5 percent a year without special permission.*	*"Automatic" permission to grow was previously available only to some metal manufacturing industries. This liberalization did not apply to large companies or to items reserved for production by small-scale industry.*
September 1980	*Prominent industrialists met with Gandhi, acknowledged a new orientation in bureaucratic procedures in response to her push for production.*	*Industrial leader characterized changes as "probation rather than reprieve" for big business.*
October 1980	*Export sales excluded when determining whether a company is large enough to be subject to especially stringent limits on growth.*	*Change benefited the large companies that were excluded from the July liberalization.*
November 1980	*Ceilings on debt and on interest payable on company debentures relaxed.*	*Change intended to increase the flow of nonbank funds to the private corporate sector.*
March 1981	*Maximum share of equity that may be held by promoter of a new company raised.*	*Previous restrictions sometimes conflicted with required minimum share of investment.*
October 1981	*"Regularized" capacity installed by pharmaceutical companies in excess of licensed limits.*	*This toleration of previously illegal production was accompanied by restrictions on distribution of products, especially stringent for large or foreign-owned companies.*
February-March 1982	*Cement producers permitted to sell part of their production to whomever they want at whatever price they can obtain.*	*Government still regulates price and distribution of production equivalent to two-thirds of installed capacity. Change squelched black market in cement.*
March-April 1982	*Government-administered system for setting prices of steel and pig iron abolished.*	*Prices now set by committee from five public-sector and one private steel plant under "watchful" eye of government.*
April 1982	*Authorized substantially higher capacity ceilings for companies that exceeded licensed production limits during any of previous five years. Applies even to large or foreign-owned companies in an expanded list of "core" sectors. Definition of "dominance" changed.*	*Practical impact of this relatively comprehensive change limited because many companies had underutilized capacity and definition change is unclear. Liberalization does not apply to 72 industries subject to special licensing, or to items reserved for small-scale industry.*

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The corporate sector has been given greater freedom to attract funds from outside the banking system. Companies are now permitted to pay a higher interest on debentures and on funds deposited with them. The maximum permissible debt-equity ratio has been relaxed, and new tax concessions have been allowed on investment.

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These decontrol measures have created a more favorable policy climate for investment. Large companies had hoped for more freedom, but they report ambitious expansion plans in response to Gandhi's policy changes and somewhat improved electricity and rail services. The number of industrial licenses approved rose sharply in 1980, and the private corporate sector has obtained more funds from the public and from government financial institutions. 25X1

Foreign Trade: Selected Liberalization Measures

April 1980	*Import-export policy: imports of spare parts allowed for stock and resale. Manufacturers may use REP licenses (those offered as a reward for exports) to import goods required for their own production as well as items on a "shopping list."*	*Continued modest liberalization begun in 1975 and significantly extended in 1978, when foreign exchange reserves were rising. Official text noted importance of policy stability but cautioned that liberalization is not an end in itself.*
March 1981	*Exporters of manufactured metal goods received priority in distribution of steel and pig iron. Charged international prices (lower than domestic prices).*	*Shortages of steel had been curtailing production of exportable goods.*
	Complete tax holiday for five years offered industries located in Free Trade Zones.	*These companies must export all their production.*
April 1981	*Import-export policy: extensive tinkering with lists of items that may be imported freely and those usually banned. "Trading houses" that promote rapid export growth received additional import licenses and foreign exchange allocations. Last year's liberalization of REP licenses extended to manufacturers who export through agents.*	*Most earlier liberalization retained despite new restrictions on minor items. Effort to balance objectives of protecting domestic industry and assuring access to imports needed for production, especially in export-oriented industries.*
June 1981	*Duty-drawback program expanded.*	*Refunds import tax on inputs used by exporters.*
August 1981	*Exporters allowed to deduct 133 percent of expenditure on preinvestment surveys and overseas warehouses from taxable profits.*	*Exemption previously limited to expenditure on office maintenance, travel, and advertising.*
March 1982	*Industries in Free Trade Zones allowed to sell 25 percent of production in domestic market if they pay import duty on such sales.*	
	Companies that increase exports by at least 10 percent allowed tax relief on 10 percent of their export profits (25 percent of profits on overseas construction contracts).	
April 1982	*Import-export policy: manufacturers who export all their production allowed to import almost any input they need. REP licenses may be used to import capital goods even if a domestic substitute is available. REP licenses may be traded among exporters. Increases of 10 to 20 percent over value of past import licenses allowed without special permission.*	*Major liberalization of procedures for exporters reduced need to seek bureaucratic approval of imports. Provided limited competition for domestic manufacturers of capital goods. Overall import liberalization maintained despite official concern over poor balance-of-payments position.*
June 1982	*Duty-drawback rates increased. Coverage extended to additional items, including turnkey projects.*	*90 percent of India's exports now eligible for this program, which refunds 6 to 15 percent of the f.o.b. value of exports.*
August-September 1982	*Interministerial committee resisted pressure to protect manufacturers of soda ash, PVC, polyester and viscose fiber from import competition.*	*Since May 1982 major industrialists who previously supported import liberalization have complained about dumping of foreign goods. Businessmen who use these products prefer to buy cheaper imports. According to press reports, official nonaction was prompted by need to contain domestic production costs and thus accelerate exports.*
September 1982	*"Cash compensatory support" extended for three years with reduced benefits for most exports.*	*Program reimburses exporters for some indirect taxes and market development expenses. Indian officials deny that these payments, 4 to 18 percent of f.o.b. value of exports, are subsidies.*

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Foreign Trade. In a major departure from New Delhi's traditionally conservative management of foreign trade policy, Gandhi has avoided renewing curbs on imports of industrial equipment and raw materials even though India's trade deficit has seriously deteriorated since 1980. She has even stepped up the import liberalization begun in the mid-1970s when foreign exchange reserves were growing.

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The import licensing system has been simplified and new incentives offered for exporters. Fewer bureaucratic approvals are required before a license is granted. Manufacturers with a recurrent need for imports now receive automatic increases in the value of their import licenses. Restrictions on the use of import licenses offered as a reward for exports have been substantially loosened. The few manufacturers who export all their production may import almost anything they need.

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New Delhi has even begun to tolerate very limited import competition for domestic manufacturers. Under revised regulations, successful exporters may sometimes import a limited amount of capital equipment even if an Indian substitute is available. Since last May leading industrialists have publicly complained that they are losing sales because of foreign dumping. An interministerial committee set up to review import policy has so far, surprisingly, refused to accommodate them.

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Recognition of the need to increase exports pervades Gandhi's economic strategy. Exporters are the prime beneficiaries of relaxed controls on industry, imports, and foreign investment. The government has granted exporters increased income tax relief and changed the form of reimbursement for indirect taxes and market development expenses to minimize foreign criticism. Gandhi's efforts to alleviate infrastructure bottlenecks are intended in part to facilitate production of exportable manufactured goods.

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Benefits derived from Gandhi's trade policy shifts are not yet apparent in preliminary trade data. Although overall export performance has been lackluster, sales of goods most affected by import controls or export incentives have held up reasonably well in a depressed world market. Evidence of improvement in the production base for future export growth is mixed. Exporters have increased their use of import licensing incentives, but the volume of capital equipment imports grew only modestly in 1980/81 and declined in 1982.

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Foreign Investment and Technology. Indian policy now encourages technical cooperation with foreign business and has become slightly more receptive to equity investment proposals, reversing the direction Gandhi followed during her earlier term of office. The Foreign Exchange Regulation Act (FERA) of 1973 imposed a 40-percent limit on foreign equity in most companies, although it permitted a higher share in high technology or export industries.[3] The succeeding government implemented this legislation and added an effort to forgo foreign ownership even in crude oil exploration.

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In our view, Gandhi is now convinced that advanced technology can help make Indian industry far more efficient at home and competitive abroad.

Gandhi and her advisers still prefer to acquire foreign skills through licensing and technology agreements rather than equity investment. In support of this approach, procedures for approving nonequity "collaborations" have been simplified, and increased royalty rates are allowed. More important, implementation of existing regulations has been liberalized. Some foreign companies have been able to generate substantial equipment sales to India by offering to license some of their technology.

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A somewhat more accommodating approach toward new equity investment is also evident. Although projects that contribute advanced technology or promote exports are still favored, officials now seek opportunities to highlight the flexibility with which they will consider suitable proposals. During an interview with a leading Indian newsmagazine, Gandhi observed that

[3] This legislation affected about 900 companies. Coca Cola, IBM, and about 50 others chose to suspend operations in India rather than comply. Permission to retain more than 40-percent equity has been granted to about 150 companies. The applications of a few tea and pharmaceutical companies are still pending.

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Foreign Investment and Technology: Selected Liberalization Measures

May 1980	*Two major multinationals permitted to retain 51-percent equity in their Indian subsidiaries.*	*Indicated government willingness to make use of discretionary exemptions to 40-percent equity limit, as permitted by existing legislation.*
July 1980	*Industrial policy statement welcomed foreign investment in certain cases.*	*More accommodating emphasis than policy statements of previous government, which discouraged foreign investment except in certain cases. Legislation unchanged.*
September 1980	*Foreign oil companies invited to bid for exploration and production-sharing contracts.*	*Invitation had been planned in December 1979 but delayed by change of government. Reversed 1978 decision to forgo foreign equity, which followed unsuccessful exploration by foreign companies in 1974-78.*
October 1980	*Investment by OPEC countries permitted even if no technological benefits expected.*	*First interest in investment as source of finance rather than of technology or export assistance. This concession to attract surplus OPEC funds was not considered a precedent for general liberalization.*
	Foreign investment allowed in razor blade production with 24-percent equity (raised to 30 percent in February 1982).	*Rare example of permission for investment in a consumer goods industry. Intended in part to provide competition for domestic industry.*
November-December 1981	*During meetings in India, officials noted that foreign investment is not contrary to self-reliance.*	*New receptivity to selected foreign investment widely discussed in the Indian press.*
March 1982	*Chevron signed oil exploration and production-sharing contract.*	
April 1982	*Five additional industries opened for foreign investment.*	*Liberation applied even to large domestic companies.*
May 1982	*Hindustan-Lever permitted to retain 51-percent foreign equity.*	*Decision risked public criticism, since part of production consists of consumer goods for the domestic market.*
July 1982	*Restrictions on domestic trading by foreign companies modified.*	*This change applied to trading in products of public-sector, small-scale, or unprofitable industries. Unusual recognition of economic value of marketing skills.*
	Gandhi actively solicited foreign investment during visit to United States.	
April, July, August 1982	*Limits of equity participation by nonresident Indians in portfolio shares and new issues relaxed.*	*Repatriation of capital and interest permitted.*
August 1982	*Foreign oil companies again invited to bid for exploration and production-sharing rights.*	
October 1982	*Japanese company signed investment agreement for assembly of passenger cars with public-sector firm.*	*Critics considered project a memorial to Gandhi's deceased son, who favored it.*
	Foreign company already active in India plans technical transfer to public-sector company. Will accept marketing rights, in India and abroad, to half of output in lieu of royalty.	*Proposal, not yet approved by government, evades limits on expansion of FERA company. Also recognizes value of international marketing skills.*
November 1982	*Nonresidents permitted to remit proceeds from sale of shares without prior permission of tax authorities.*	*Repatriation of any profit must still await tax clearance. Part of continuing effort to attract nonresident investment.*

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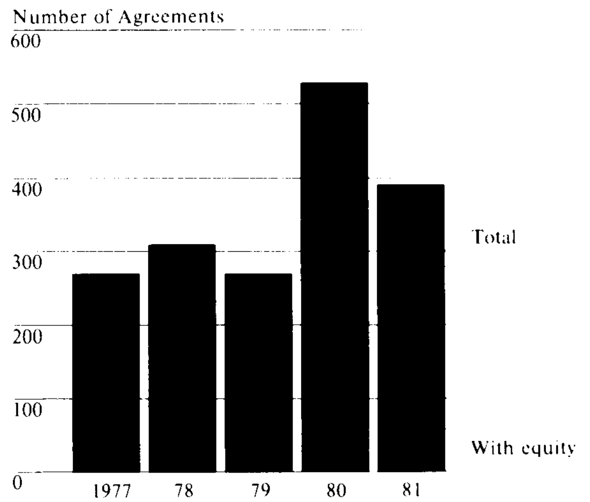
"as we have grown stronger we are liberalizing . . . . Now we're allowing foreign capital in previously forbidden areas . . . because we want to accelerate our own growth without compromising self-reliance." [redacted] 25X1

Experience has tempered New Delhi's efforts to restrain foreign companies already active in India. According to press reports of stock exchange activity and company negotiations with the Indian Government, many large companies complied with FERA legislation by increasing their capital base through the sale of shares to Indian nationals. The foreign owners were thus able to retain management control and expand their activities without having to contribute additional capital. Since Gandhi's return, several prominent multinationals have been allowed to retain 51-percent equity, and restrictions on the domestic trading activities of companies subject to FERA have been loosened. Press reports indicate that New Delhi is seriously considering a major policy change to encourage foreign investors who earlier diluted their equity to bring it back up to 51 percent—provided they contribute new funds, invest in approved sectors, and accept an obligation to export part of their production. [redacted] 25X1

Figure 1
Foreign Technology and Investment Agreements, 1977-81



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A marked liberalization for three exceptional types of foreign investment shows interest in foreign financial benefits:

- Foreign oil companies have been invited to bid for exploration and production-sharing rights in several areas of India, and a contract has been signed with Chevron.
- Nationals of the OPEC member countries are welcome to invest in India even if they are unable to contribute technical skills.
- Portfolio investment from Indians resident overseas is now encouraged. [redacted] 25X1

An impressive increase in the number of collaboration agreements approved has followed Gandhi's policy changes, and her welcome to foreign equity, while still ambivalent, has been sufficient to retain significant foreign participation in the Indian economy. Major manufacturing projects with an investment outlay of more than $1 billion are under way or proposed by foreign companies already active in India.[4] In addition, several multinationals are negotiating major projects that combine a limited amount of equity investment with licensing agreements. [redacted] 25X1

Foreign Commercial Borrowing. A more accommodating approach to the use of foreign commercial loans accompanies the liberalization of trade and industrial regulations. This reflects a major, albeit reluctant, change in India's conservative financial policy, which previously relied predominantly on concessional aid. Before 1980 a few public-sector institutions were allowed to tap international capital markets for less than $100 million annually, but commercial loans and European government export credits have only recently begun to play a major role in financing Indian imports. Public and private-sector

[4] Most of the cost will be financed within India. These projects constitute less than 2 percent of the total investment plans reported by an Indian research firm [redacted] 25X1

organizations arranged more then $2 billion in nonconcessional loans during the past two years. The IMF anticipates a sizable step-up this year and estimates that disbursements could provide more than $500 million. [redacted] 25X1

Most government borrowing will be used for large projects, aircraft purchases, and relending to industry, according to published data on international loans. New Delhi negotiates syndicated bank loans for major projects along with foreign government export credits and concessional aid—a practice that lowers the average interest rate but limits the choice of supplier. Direct borrowing by the private sector is permitted for projects approved by the governmment and accounts for about 40 percent of total nonconcessional loan commitments. [redacted] 25X1

Government financial officials have expressed concern that India's currently low debt service ratio will rise beyond prudent limits unless borrowing is carefully managed. Not only does market borrowing entail high interest rates, but an increased share of World Bank loans and part of the IMF credit are on commercial terms. Gandhi has complained to US officials that India is being punished for its success in becoming creditworthy and resents US efforts to link a reduction in multilateral aid with New Delhi's ability to borrow more commercially. [redacted] 25X1

Limits of Liberalization.
Liberalization measures undertaken so far do not amount to a comprehensive revision of economic strategy even though they provide significant new opportunities for key economic sectors. Most policy changes have been designed to spur exports, minimize shortages anticipated by bureaucrats, or shift some investment costs out of the government budget. Gandhi has told interviewers that it would not be desirable to open the economy to market forces. She remains suspicious of big business—domestic and foreign—though she is willing to see what it can accomplish if given more freedom. [redacted] 25X1

Private business is not yet free to invest or produce whatever it deems profitable. Officials repeatedly emphasize in public statements that industrial controls must be maintained in order to make best use of the capital available. The Ministry of Industries continues to seek increased authority to punish companies that exceed authorized production limits. Potential benefits from policy changes have been delayed because of uncertainty over the interpretation of new regulations. Although some industrialists see a speedup in official procedures, press reports suggest that many officials continue to believe their job security is best served by scrupulous application of antimonopoly legislation. [redacted] 25X1

The basic regulatory structure governing foreign trade—lists of items that may be imported freely, sometimes, or only rarely—remains in place. The government still restricts most imports when domestic production increases, and high tariffs provide additional protection. Imports of most manufactured consumer goods are still prohibited. Gandhi remains unwilling to permit exports, particularly of agricultural commodities, that might lead to shortages in the domestic market. [redacted] 25X1

Foreign investment policy remains highly restrictive despite the changes made during the past two and a half years. Gandhi has told interviewers that she prefers to steer clear of large multinational firms whenever possible. New Delhi still discourages proposals intended to take advantage of a protected domestic market, restricts production by pharmaceutical companies, and only rarely permits investment that threatens established domestic manufacturers. [redacted] 25X1

New freedom for private corporations does not, in our view, imply a reduced role for the public sector, nor elimination of policy discrimination against big business.[5] Predominantly government-owned industries such as petroleum exploration and refining, electricity, and steel also have major expansion plans, and they, too, benefit from import liberalization. Some manufacturing remains reserved for small producers, and both agriculture and small-scale industry still benefit from priority in the allocation of bank credit. The government continues to intervene in the purchase and distribution of foodgrains and sugar. [redacted] 25X1

[5] The public sector accounted for one-fifth of India's GNP in 1980/81 and about 14 percent of net national product in maufacturing in 1979/80. [redacted] 25X1

Prospects for Continued Liberalization

We believe Gandhi regards her liberalization program as an experiment—worth an extended trial but to be abandoned if output and exports fail to increase. In our judgment, she is prepared to ignore much criticism but would reinstate some controls if business and political opposition seems likely to attract widespread popular support during an economic downturn. We believe Gandhi will extend her liberalization efforts if the economy performs well—good weather and prompt oil discoveries would ease the foreign exchange risk her policies entail, and prosperity would mute domestic criticism. 25X1

Domestic and Foreign Influences. Pressures to maintain liberalization will probably be slightly stronger than those for retrenchment during the next several months. International lending agencies strongly endorse the relaxation of controls, while the positions of domestic interest groups are inchoate. As a result, we believe New Delhi may provide relief for industries most hurt by imports but will continue most of the decontrol measures already announced. Gandhi, however, probably will not risk much further liberalization of industrial imports when the annual trade policy statement is released next April—import costs are already higher than anticipated because of poor weather last summer. 25X1

Business support for liberalization is ambivalent, judging from extensive comment in the financial press and company reports. Many larger industrialists who have benefited from an improved supply of imported materials and increased investment opportunities would oppose renewed controls. Other businessmen depend on a protected domestic market and resist liberalization. Some manufacturers not only complain of foreign dumping but also of "unfair" competition from foreigners who are more efficient because they produce on a larger scale. Potential exporters argue that high-cost domestic inputs and unreliable supplies of power and rail services prevent them from diverting production toward foreign markets. 25X1

Although economic policy is not yet a popular political issue, opposition parties have already begun preparing to exploit potential discontent. During parliamentary debate the leftist parties cooperated with a Hindu nationalist party in accusing Gandhi of selling out to multinational companies and financial institutions and abandoning India's traditional self-reliance. Gandhi's spokesmen are reluctant to jeopardize her popularity, and so they minimize the welcome for foreign business when addressing domestic audiences. 25X1

In our view, policy conditions imposed by the International Monetary Fund inhibit Gandhi from backsliding on the liberalization program she began on her own initiative. The IMF advocates fewer restrictions on industrial production, further export promotion efforts, and continued import liberalization. Access to $3.5 billion as yet undisbursed from an Extended Fund Facility credit is contingent on satisfactory performance. IMF leverage will be reduced after mid-1984 when this loan will be fully drawn. 25X1

Foreign Exchange Constraints. Our assessment is that a potential shortage of foreign exchange is the greatest threat to continued liberalization. We believe India has only an even chance of avoiding severe strains on its international payments position by late 1985 or early 1986. Gandhi may modify her policies before then in order to ease the anticipated problems. She probably will not encourage domestic industry to grow by using more imported materials when such purchases would jeopardize India's ability to pay for imports of food, petroleum, or military equipment. 25X1

Developments beyond the control of Gandhi's policy will partly determine India's ability to finance continued economic liberalization, in our view. New Delhi is counting on increased domestic oil production to reduce import costs, but no discoveries have been confirmed since 1977, and production from existing fields will level off by 1985. India is only intermittently self-sufficient in foodgrains, and import requirements depend largely on the weather. Exports of several commodities are now inhibited by slack demand in Western countries. Some commercial bankers have become reluctant to increase their exposure in India, in part because of the fallout from financial crises in Latin America and Eastern Europe. 25X1

Uncertainty about future foreign aid receipts has heightened New Delhi's concern about a foreign exchange shortage. During Gandhi's visit to Washington last July, she and her advisers observed that it would be difficult or impossible for India to continue economic liberalization without access to concessional loans. Although this argument was intended to elicit greater US support for Indian borrowing from the International Development Association and the Asian Development Bank, in our judgment it also reflects valid concerns about balance-of-payments prospects after 1985, when repayments to the International Monetary Fund must begin. [redacted]

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Implications of Liberalization

Policy Overview. Gandhi's changes reverse the restrictive trend of key economic regulations but do not move very far in the new direction nor set policy securely on the path toward further decontrol. In our judgment, Gandhi has no comprehensive strategy for economic reform. Regulatory change was well under way before the business press or later, Gandhi herself, acknowleged a general liberalization. She still uses the nearly meaningless rhetoric of socialism and self-reliance while embarking on a pragmatic effort to lower barriers to industrial growth. Although liberalization provides greater scope for business decisions, the new freedom is precarious because the basic regulatory structure remains in place. Gandhi will probably extend her incremental decontrol efforts if the benefits to production and exports become apparent, but she could easily reverse them if financial stringency or political expediency warrant. [redacted]

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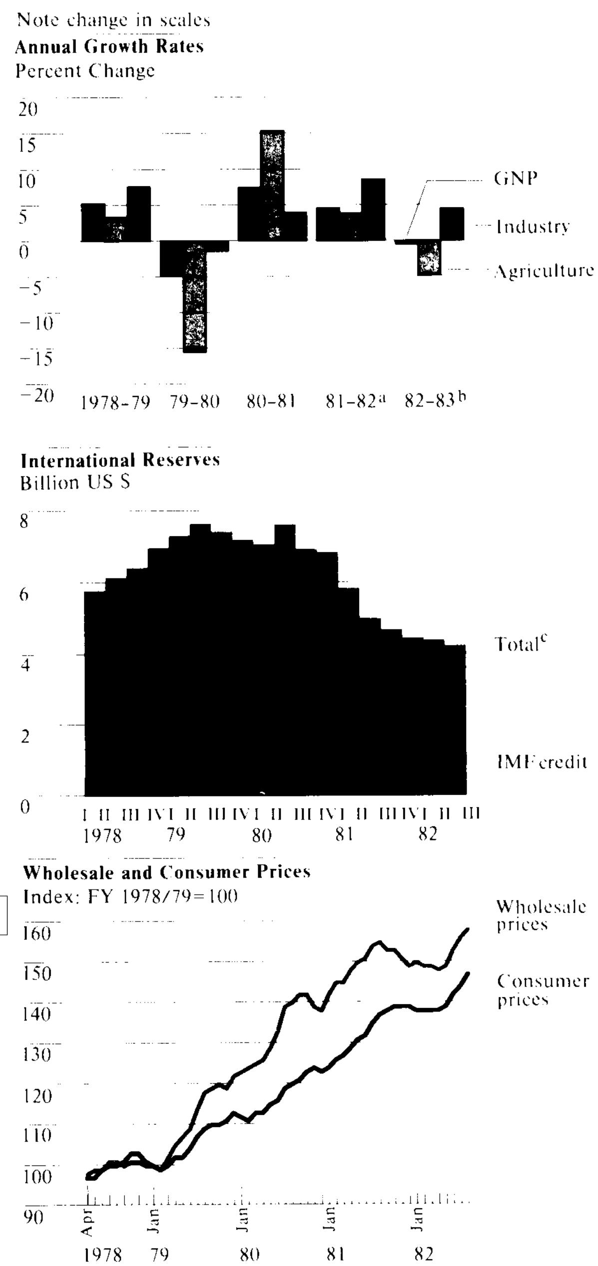
Domestic Economy. Gandhi's economic policy changes are important because they imply a recognition that bureaucratic controls and protection often prevent Indian industry from becoming efficient. But the potential benefits can be realized only if domestic or foreign demand is adequate and if the supply of electricity and rail services improves further. Sustained economic growth in India requires satisfactory weather and success in containing petroleum import requirements as well as more aggressive decontrol efforts. Gandhi's liberalization efforts could even contribute to the severity of an economic downturn; higher current imports and greater commercial bor-

Figure 2
India: Selected Economic Indicators



[a] Preliminary data.
[b] Projection.
[c] Excluding gold.

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[redacted]

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rowing reduce the foreign exchange reserves that will be sorely needed if India suffers another poor monsoon next year or fails to discover additional petroleum reserves.

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Benefits from Gandhi's policy changes are not yet evident in overall Indian economic performance. GNP growth slowed last year and will probably stagnate this year. Industrial gains are moderating, and foreign exchange reserves continue to decline. Inflation, which abated late last year, again worries policymakers, according to press reports of their speeches. Poor weather and labor disruptions account for much of the deterioration and have obscured the potential benefits of decontrol. Nevertheless, economic performance data have given Gandhi little proof that her limited liberalization efforts have helped raise the country's output.

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Foreign Policy. Economic liberalization is only loosely linked with Gandhi's simultaneous efforts to put greater distance between India and the Soviet Union and improve her nonaligned image. Both the domestic and foreign policy trends are prompted—in part—by the increasing sophistication of the Indian economy, which makes New Delhi reluctant to purchase inferior Soviet technology and increases interest in commercial ties with Western countries.

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Even if trade and technology links with Western countries increase substantially, Moscow will retain a central place in India's foreign policy strategy. The Soviets provide what India believes it must have—political support against Pakistan, a credible deterrent to China, and modern weapons on attractive terms. In addition, we believe Gandhi is not confident of continued access to Western markets or aid flows and would not jeopardize her ability to turn to Moscow for economic support. Conversely, we expect Gandhi to continue moving toward a more balanced foreign policy even if she reimposes some controls on imports or industry

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Indian economic policy changes generate additional commercial ties with the United States but also add to the risk of political friction. New Delhi will increasingly encounter US export controls as it seeks to import more technically sophisticated equipment. US businessmen who tangle with the Indian bureaucracy for the first time will complain about the extensive regulations that remain rather than praise decontrol. More important, the United States would probably be a scapegoat for an economic downturn—some Indian officials would attribute part of the trouble to lack of US financial support for multilateral lending institutions that favored liberalization, while opposition parties would accuse Gandhi of abandoning self-reliance at the behest of the United States.

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